DOW THEORY LETTERS INC.

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THE BEAST: I started wrestling with the great stock market beast in late 1945. I've got shelves of stock market and economics books to attest to my struggles. I've tried the dollar averaging plans, the formula plans, the fundamental approaches, the cycle theories (and I mean strict cycles based on time periodicity). I've tried the yield cycle method, the techniques of the in-and-out traders, the "sit tight and have faith in America" approach. I've wracked my brains over every technical method I could ever get my hands on from the odd-lots to the short interest studies, from moving averages, to the Elliott Wave Principle.

In twenty-nine years of studying the market I must confess that the dark secret I've always harbored is really no secret at all. And I'll reveal it here and now. There is no perfect method for beating Wall Street. Wall Street has learned to discount and beat any method or device ever invented.

And of course the logic of that statement is simple enough. The day that you or I or anyone else develops the perfect system, on that day Wall Street will cease to exist. For in a matter of days or perhaps months we would have accumulated all the money on this tortured earth. Friends, it isn't about to happen.

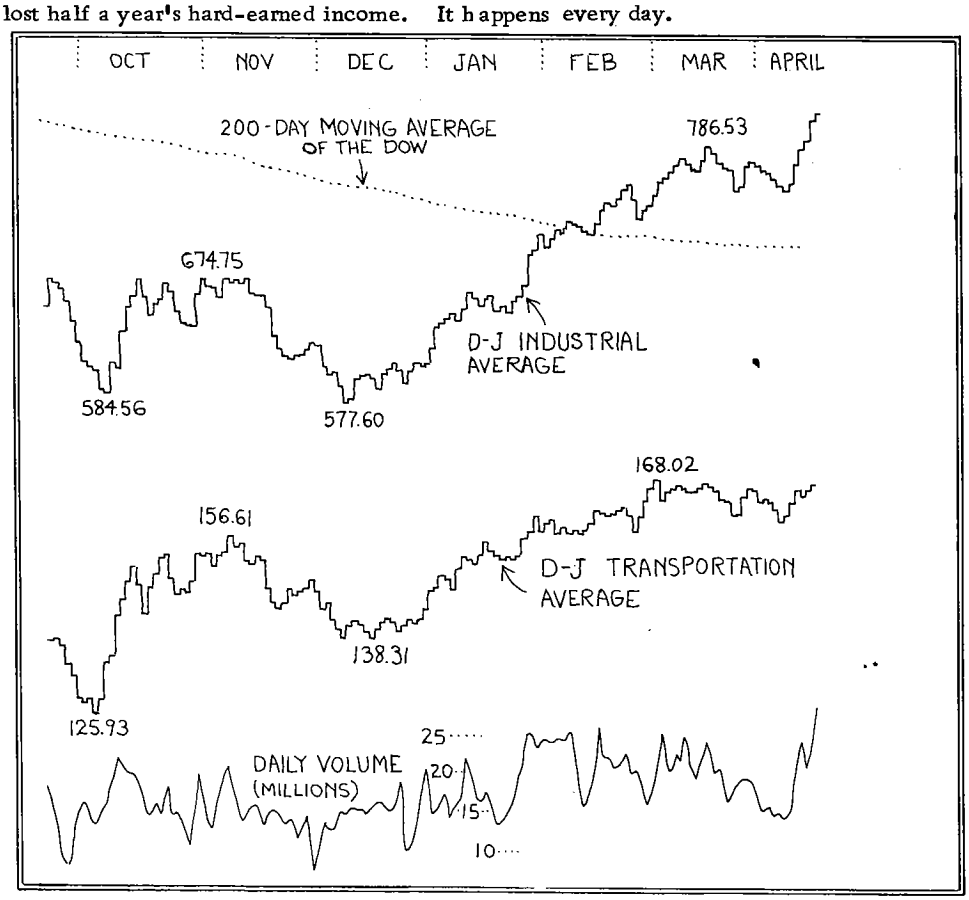
"You're a big help, Russell," you say, "tell me more about how I can't function in the stock market. And maybe while you're at it you can send me a refund on what's left of my subscription."

Hold it, I reply, I'm not finished yet. The fact is that I've found something in almost every stock market method I've studied, and a great deal in a few. In fact, I'd say that (1) intuition, plus (2) guts, plus (3) knowledge, plus (4) a lot of hard work, plus (5) great patience, plus (6) control over your natural greedy tendencies WILL (over a period of years) allow you to take out more money from the stock market than you put in.

"C'mon, Russell," you retort, "what the devil do you think I am, some kind of genius-saint? You're asking too much. Nobody can fill that prescription!" My answer is that a lot of people fill those requirements. And do you know something, almost everyone who is successful in his own business possesses many of those same attributes — except, of course, that his talents happen to apply to real estate or the law or making shoes or running a bakery. And that's the amazing part of it. A man who is successful at say running a scrap steel business thinks that the stock market is a snap. He goes in at the wrong time buying the wrong stocks on 50% margin and presto, he's lost half a year's hard-earned income. It happens every day.

What's the answer? One answer for me has been obsession. I've studied and lived with the stock market so long and intensely that I can smell it in my sleep, I can see the statistics ticking by as I walk along the beach, I can visualize those price patterns dancing before my eyes when I eat breakfast. Another huge help to me has been Dow's Theory, the single most reliable market approach ever devised. And I'm not talking about Dow's Theory simply as a study of the price structure, I mean the whole Dow Theory along with its concepts of values, phases, public and investor sentiment, plus Robert Rhea's remarkable techniques and observations for "reading" the Averages.

Along with Dow Theory I add dozens of other methods that most older readers are now familiar with, plus anything else I can think of that may pertain to the situation. And I try to stay humble (is it humble to even admit this?) when dealing with the market. If you insist on making (forcing) your own "new system" to work, the mar-



 ket will ultimately destroy you. If you think that since you have a gimmick that worked in 1960 and 1970 and 1974, it MUST work now, duck, friend, because Wall Street is about to take your head off.

I've learned that there are times when you have to pray, there are times when you have to stand alone (and I mean all alone), there are times when you have to kick out your own favorite indicator or system, there are times when you have to reverse your entire stance because the market is telling you you're 100% wrong.

But of all the approaches the Dow Theory approach has worked best for me. It's worked best because it really is not a system but a body of working knowledge. Dow's Theory doesn't come up with THE ANSWER, but it does provide hints and indications. It's up to you to try to make answers out of those indications — if you can.

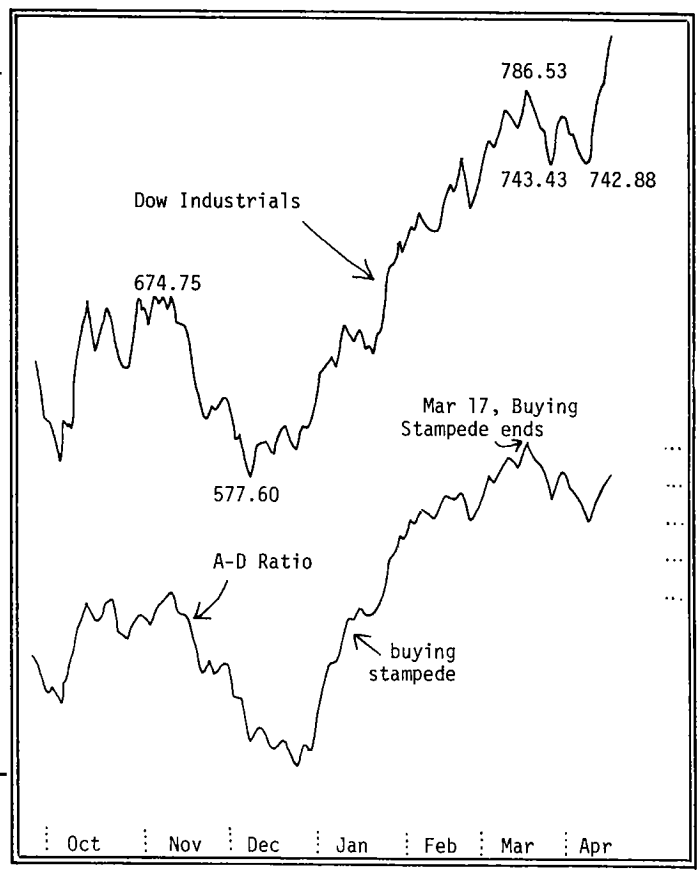
For instance, not every "bull signal" pattern in the Averages is valid. There have been fake-outs and deceptive signals. There have to be or Dow's Theory would be the simple formula that any fool could make money with. It's not. It's an approach to the market that has helped serious students for over 70 years. I never would have made a nickel without it. As Robert Rhea, the great Dow Theorist of the 1930's put it, "Those gain most from the Theory who expect least from it."

I want to close this rather wordy introduction with an observation. Everything that's wrong with your character, every defect, will show itself in your market operations. If you're greedy, you'll lose money because you'll want to beat Wall Street on every move. If you're impatient, that will cost you money because you won't wait for the market to tell its story. If you're hard-hearted the market will find a way to cost you. If you're tyrannical, you'll end up telling the market what to do — and it won't listen. If you lack humility, the market will find a way to bring you to your knees.

The market is made by the minds of men, and as such it is a study of the minds of men. Wall Street is a great teacher, one of the greatest. If I personally have learned two lessons from Wall Street they are patience and humility. When asked what he could do, Herman Hesse's Siddhartha said, "I can fast, I can think, I can wait." Just as Siddhartha knew his strengths and sought to correct his weaknesses, it would pay the market practitioner to do the same. Draw up a list of your strengths and weaknesses. Then try to see how they help or hold you back — both in life and in the market. You will find that such a study can be invaluable.

THE MARKET: Last week opened with a "bang" on Wall Street. Gold bullion on Monday (April 14) plunged below the much-watched $170 level for the first time in five months while gold shares gapped to lower levels. At the same time the Dow rocketed up more than 17 points. Despite the big Dow gain, it is clear that the market is no longer a dart board with the thrower taking all. The big buying stampede of December to March ended on March 17, and the April climb is much more selective and much more oriented to high-quality, Dow-type stocks. And the market is a harder place in which to make money.

In the last Letter I wrote that for the first time in 1975 the market is being confronted with technical problems. I added that if Industrials broke the 743.43 level and this was confirmed (see page 1 chart) by Transports breaking their 160.44 level, I would consider the secondary trend of the market to be down. Exactly this occurred on April 7, with both Averages breaking their preceding lows on very light volume. The market immediately turned around and started rallying (April 8). On April 11 the Industrials rallied strongly and closed above their March peak of 786.53, thereby recording a new 1975 high. Transports have refused (so far) to confirm. I will remind readers that under Dow Theory a movement of one Average, unconfirmed by the other, is meaningless for predictive purposes — and more often than not deceptive.



In the last report I also wrote that the lagging advance-decline line presents another technical problem. Please refer to the chart of the A-D ratio and the Dow on page 2. I felt that (1) the Dow and the A-D ratio could break to lower levels without the Dow first going to a new high, and I wrote that I would "prefer" this kind of action, or (2) the Dow could rally to a new recovery high, a high which would almost surely not be confirmed by the A-D ratio. With such a non-confirmation, I felt that the market could be placing itself in position for a more extensive correction.

Ironically, Wall Street then proceeded to deliver both events. On April 7 the Industrials broke below the 743.43 level with the A-D tracing out a definite downward zig-zag pattern. The Industrials then reversed and rallied to a new high. As seen on the chart, the A-D ratio failed by a wide margin to confirm the new 1975 high in the Dow.

We now have the first important non-confirmation between price (the Dow) and breadth (the A-D ratio) in 1975 (see chart). The question is asked, "What would happen if the A-D ratio followed the Dow up to new recovery highs?" The answer is that such action would sound the all-clear signal. But I might add that once the

Dow and the A-D get this far out of gear, it is extremely rare for the problem to be resolved by new highs for the A-D. The more usual development is upward strain, a persistent refusal by the A-D to confirm on the upside — and then a correction.

I want to add that we have (at this writing) a single non-confirmation between price and breadth. I would not care to see a series of two or more non-confirmations, such as a decline of a few days or so and then another new high on the Dow (again unconfirmed by the A-D). Many of the most serious market declines have been prefaced by a series of double or triple non-confirmations between price and breadth.

W e should never forget that this is a primary bull market, and in a bull market it is prudent to give the upside every benefit of the doubt. Therefore, in answer to dozens of queries I've received regarding shorting this market, my answer remains a resounding "No!" It's one thing to take profits in a bull market and quite another to short it in anticipation of a reaction. The latter is simply a financial version of Russian Roulette. Keep trying it, and you'll end up with a lot of experience and very little in the way of cash.

Many people seem incapable of understanding the difference between missing possible profits and taking a loss. Thus, selling out before the top of a move means taking some but not all the possible profits. Personally, I've never met a man who was good enough to "get it all," but such a miracle trader may exist. On the other hand, taking a loss entails an actual loss of capital, and as any intelligent market operator knows, your capital is your basic "tool" in the stock market. Getting out before a potential top represents the "cost of insurance" in the stock market. When you buy a life insurance policy you don't grumble because you haven't dropped dead yet. But many neophyte investors are prone to complain when they take profits and the market rises for a while longer.

Question: Why is the non-confirmation principle between the Dow and the Transports or the Dow and the A-D ratio so important? Why must we be so wary of these situations? Answer: The rationale for the Dow and the Transports is as follows: The Dow Industrials are representative of the manufacturing capabilities of the nation. The Transports reflect the selling and shipping capabilities (if you sell the goods, they've got to be transported). If corporations manufacture but don't sell (and ship), they're in trouble. Conversely, if corporations ship out the goods but manufacturers are shutting down for lack of new orders, trouble is looming on the horizon. Thus, a harmonious rise in Industrials and Transports reflects a healthy industrial machine. Contrarily, non-confirmations indicate that something is "out of whack" between the sales force and the manufacturing force, and the result is usually trouble in the market and elsewhere.

As far as the Dow and breadth is concerned, a study of 45 years of market history shows that there is also a normal or harmonious relationship between the Dow (composed of 30 corporate giants) and the rest of the market (as represented by the A-D ratio). When economic forces are such that they help only the blue chip Dow companies (but not the thousands of other corporate entities), we generally see it reflected in the market in the form of a divergence between the Dow and the A-D. That divergence can spell trouble ahead.

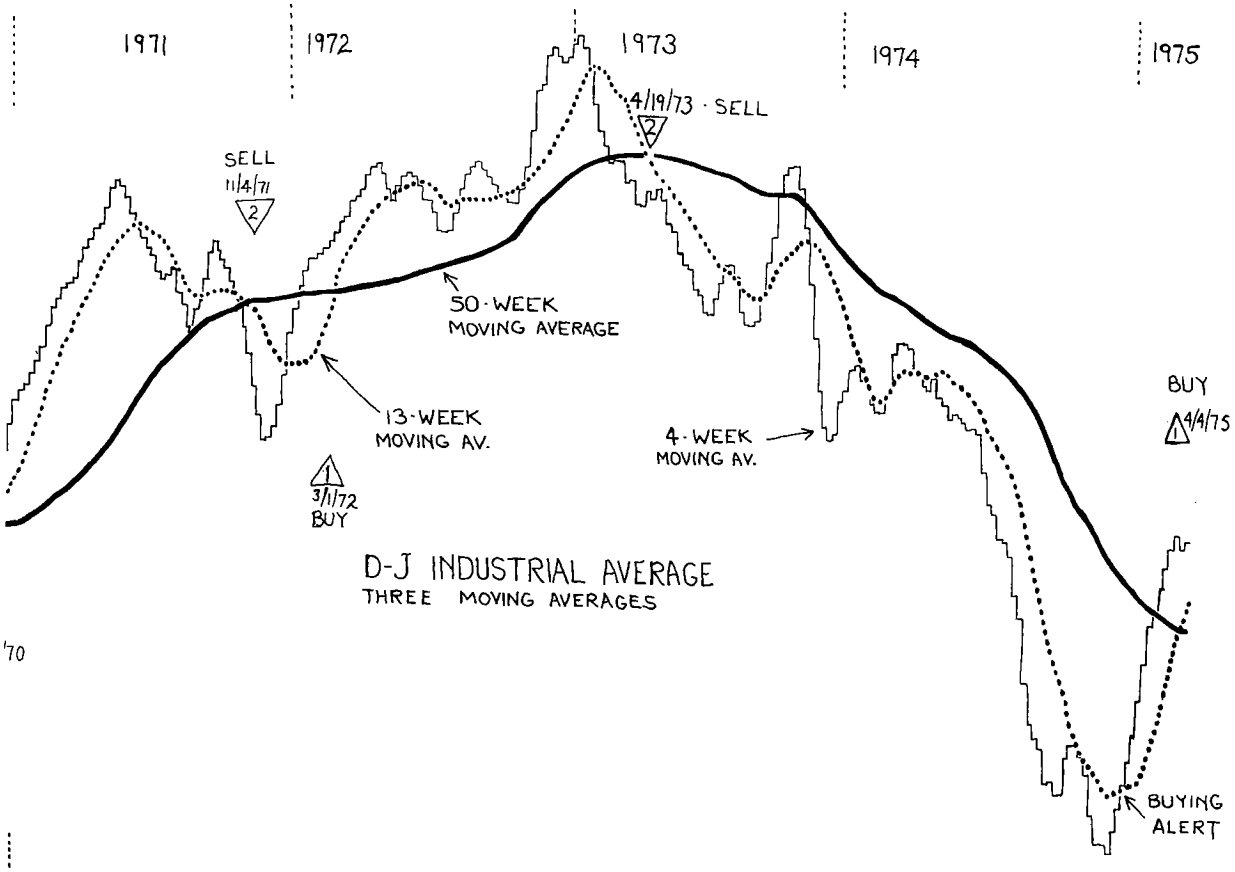
A strained economy or a strained technical situation in the market can result in a parting of the ways between price and breadth. History indicates that the market ususally cancels out the movement that produced the unhealthy divergence or non-confirmation. And that is why we may be getting a preview of lower prices for Wall Street over the several months ahead.

I want to add here that our old friend Will-Go is pointing to a bit of trouble on the horizon. Will-Go is a function of the spread in the yields between the Dow Industrials and Barron's 10-High Grade Bonds. That spread was 3.91 last week, highest (in favor of bonds) since October. Will-Go (so named because where it points the market will go) is now suggesting a two-step reaction carrying at least into late-June. I'm not going to go into a detailed discussion of Will-Go at the point, but older subscribers remember that Will-Go can often be "on the beam" (unless it gets too big a following).

MOVING AVERAGES: As older readers know, I keep a study that consists of three moving averages of the Dow, a short-term or 4-week MA, an intermediate-term of 13-week MA, and a long-term or 50-week MA. Crossings of the three MA's provide the signals under this study. Any time the 4-week MA crosses above or below the 13-week MA, we have what I term a buying or selling alert. These alerts can come rather frequently and can therefore lead to "whipsaws." When an alert is given in the direction of the primary trend, however, it is often worth acting on. As seen on the chart (page 4), a buying alert occurred on January 16, 1975 in the bullish direction (of course we guessed it was bullish at the time, and the actual bull signal came a few weeks later on January 27).

The more important signals under this study come when the 13-week MA crosses above or below the 50-week MA. These signals occur much less frequently, and as you can see on the chart only three signals have been given since 1971. Again, I pay considerably more attention to these signals when they occur in the direction of the prevailing primary trend. Thus, I was not particularly impressed by the "bull signal" of March 1, 1972 (see chart page 4), but I was most emphatic about the "bear signal" of April 19, 1973. Those of us who abided by the April, 1973 signal were lucky enough to be on the sidelines during the worst market fiasco since the 1930's.

I am presenting the MA study at this time because on April 3, 1975 the 13-week MA moved above the 50-week MA for the first time in three years. This crossing came following a 474 point collapse in the Dow (during 1973-74) and following the latest



(December to March) advance of 209 Dow points. I have written many times (and I will repeat): History shows that the greatest part of any major bull or bear movement tends to come following a bullish or bearish crossing by the 13-week and 50-week MA's. If that holds true, then we are obviously at a very interesting and important juncture in the market.

I consider this latest crossing to be long-term bullish for the market. It's always a fruitless study to debate the "why's" and "wherefore's" of a technical bullish signal. Suffice it to say that the two MA's have crossed, and they are now 15 points apart with the 13-week MA above the 50-week MA. It's bullish; the market is telling us its story, and the short sellers are obviously arguing with the tide.

As to the intermediate term, that's always a tougher and more deceptive problem than the long-term question. As I've noted before, there's no certain way of identifying the beginning of a secondary correction in a bull market or an upward (correction) in a bear market.

The Dow has now climbed approximately 238 points from its December low. This amounts to around 52 points per month since December, a very high and probably unsustainable rate. The great rise of 1962 to 1966 produced a rate of ascent equal to an average of 10.6 Dow points per month. The very powerful 1957 to 1960 rise produced a rate of ascent equal to 17.7 Dow points per month. Obviously, we have to get a slowdown somewhere along the line, and this is what a correction is all about. Another important buy-spot will almost surely arrive during the weeks and months ahead. Those with patience will take advantage of it; those who lack patience will probably end up giving back a good portion of their 1975 profits.

TRENDS AND VALUES: I believe the chart on page 5 is going to prove increasingly important as time goes by, and I will probably run it frequently in the months ahead. The chart deals with the dollar, interest rates, currency and gold. If the bull market on Wall Street is to expand and flower, it is my belief that the various relationships depicted on the chart will remain bullish in terms of the health of US stocks and the dollar. On the other hand, if the indicators on this chart start "acting up," then I expect the US and its money and its equities to run headlong into a storm.

I wanted to give the chart some historical scope, and for this reason the indicators are plotted on a weekly (rather than a daily) basis. There are two ways of reading the chart. (1) You can read the chart in the "regular" way in terms of trends, such as the trend of the 40-Bond Average was down until October, 1974, at which point the trend turned up. (2) You can read the chart from a "strength of the dollar" standpoint; for instance, the dollar bought increasing amounts of the Dow all during 1973 and most of 1974, but since December, 1974 the dollar bought less and less of the Dow (or the Dow rose in terms of the dollar).

To run through the chart, the D-J Utility and 40-Bond Averages were reviewed in the last mailing. These two comprise a basic part of my "monetary background for the stock market" stance. When the trend of both of these Averages is up (as it was from

December to late-February) I consider the monetary background for the market to be bullish. The Utility Averages topped out on February 21, 1975 at 81.96 and the Bonds topped on March 11 at 69.74. Since then, under this study, the monetary background (at least in a secondary sense) has been negative.

US Treasury bills, considered by many the safest of all yield-earning investments, hit their peaks (and therefore their lowest yields) in mid-February at a yield of 5.15%. Since then the yield on bills has crept up to about 5.7%. Because bill yields tend to be a very sensitive barometer of the short-term money market, investors are now watching the yield trends with increasing interest. Sharply increasing T-bill yields indicate (1) pressure on the money markets, (2) a move to safety on the part of investors, (3) competition with stock yields and almost always a falling stock market.

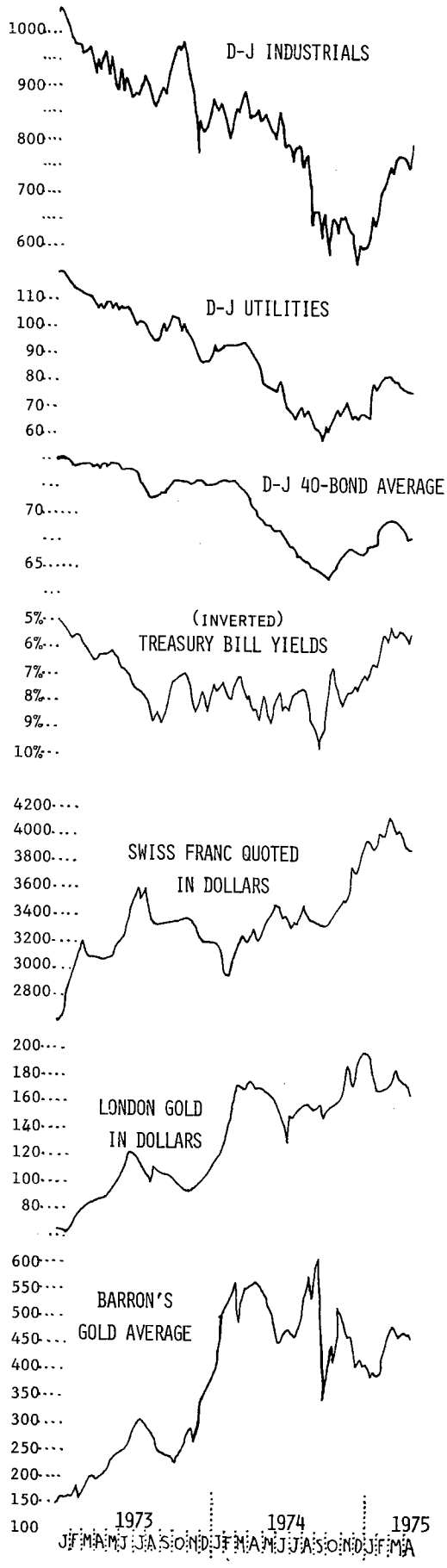
The Swiss franc (along with the German mark) represent the "port of safety" for the international investor. So great has been the recent rush into Swiss francs that the Swiss finally slapped their famous "negative interest" rate on large chunks of new money headed for Swiss bank accounts (i.e., instead of getting interest, you pay a penalty rate). The extraordinary bull market in Swiss francs was finally overdone on the upside, and as I stated a few months ago, the dollar just became too great a bargain in terms of leading hard foreign currencies. The fact is that the dollar can buy a lot more in terms of US goods than the mark can in terms of German goods or the franc can in terms of Swiss goods. When that happens, the correction comes, and it is here now. The dollar, at the moment, is becoming a real dollar, and I can get all the food I can eat for $2.60 in a number of West Coast restaurants. Try that one in France or Germany or Switzerland for a comparable amount in their currencies. In other words, don't throw those greenbacks away yet, regardless of what the pessimists on the dollar tell you.

Despite current and forthcoming huge US deficits, gold is cheaper now than it was a year ago in April (when it sold as high as $179.50). The story reads the same for the gold shares, as the chart of Barron's Gold Average (heavily weighted for ASA) indicates. Is there something wrong with gold — or the inflation thesis? I think that deflation could be the story for much or all of 1975, and I see it everywhere, particularly in the stores where price cuts and loss-leader sales are the order of the day. Ultimately, rampant inflation will probably take over, but that's a guess on the future.

As a point of interest, compare the trends of gold and the Swiss franc since February, 1974. Simply stated the Swiss franc was a far better investment than gold during this period. In fact, in terms of almost anything, the Swiss franc (and the German mark) have been the heros of the past year. Personally, I feel that the Swiss franc is still over-priced in terms of dollars. But that will remain true only while deflationary forces are at work in the US.

One final comment here: I suggested that my subscribers take profits during mid to late March, following the three-month buying stampede, and move largely into cash (or cash equivalent such as bank accounts, T-bills, liquid funds, etc.). Note that with the exception of the Dow Industrials, all the other indicators and averages depicted here are now down against the dollar. The T-bills (which are shown in yields) would also be down, since as inverted yields descend, the bills go down in price. The question: "Why is almost everything now turning down in terms of the 'lowly' dollar?" My answer is that deflation has taken hold, and the stock market and most other markets see temporary deflation as an offset to long-term or cyclical inflation, a situation which will probably create a degree of stability during 1975.

LATE NOTES: I consider that the first psychological phase of the bull market ended on March 17 at the termination of the buying panic. It seems to me that we are now near the second phase. This is the phase in which stocks advance as they reflect improving conditions for business, improving conditions on the political, social and economic front. The second phase is usually the longest phase



of a bull market. It is also the most deceptive, and it is frequently characterized by at least one very frightening secondary reaction. Whether the current second phase will develop according to the "rule books" is something we will see as time goes by. But with everything "speeded up," with instant world communications, with institutions accounting for 70% of the trading, we can expect changes and surprises — and continuing high volatility.

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During the buying stampede of late-December to March 17, each 20 point rise in the Dow Industrial Average produced a rise of 1 point on the A-D ratio. But from the recent decline low on April 7 (742.88 on the Dow) to the April 15 high (815.08) the ratio was roughly 60 Dow points for every 1 point on the A-D. Thus, it can be seen that the "rest of the market" as measured the the A-D ratio lost two-thirds of its lifting power during the April 7 to 15 Dow rally. This constitutes a decided caution signal as far as I'm concerned.

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DTL readers know that I always consider it important to note what the market does at the halfway level of a preceding advance or decline. From the record high of 1051.70 recorded on January 11, 1973 the Dow collapsed to 577.60 on December 6, 1974. This represents a loss of 474.10 points. The halfway level of the entire 1973 to 1974 decline is 814.65. On April 15 the Dow halted at 815.08, exactly .43 above the halfway level. If now, or following a correction, the Dow moves decisively above the 814.65 level, I would consider it a bullish omen for the future. If the 814.65 level proves to be a real barrier to further progress, we could have more trouble than market optimists are planning on during the remainder of the year.

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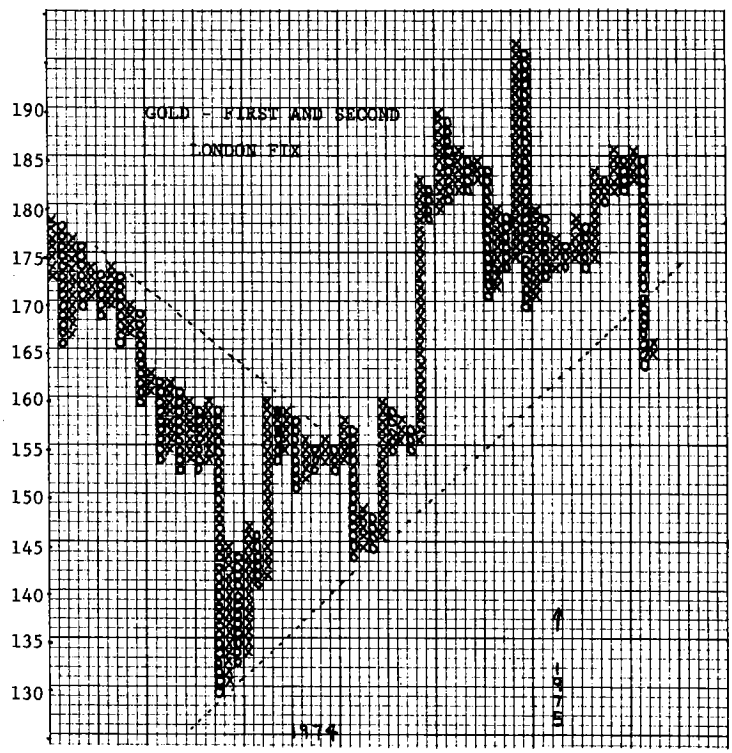
I just went through my group relative strength (RS) charts, and what I see is most extraordinary. Here are the strong groups, based on group price movement, relative strength of the group against the market, momentum of relative strength (charts furnished me by Ray*Signals, 43 Lake Ave, Montrose PA 18801). The outstanding groups are Air Transport, Hotel-Motel, Leisure Time, Mobile Homes, Motion Pictures, Publishing, Real Estate, Restaurants, Dept. Store, Shoes, Textile Apparel.

It all adds up to the consumer, who now seems (in the face of recession) to be totally "punchy." In my opinion, the American consumer is becoming immune to shock, scares, disappointments, political lies, taxes, loss of purchasing power, inflation and everything else. He is, in a word, totally zonked. There's no doubt about it, people are spending, they're living "like there's no tomorrow," and leisure time is the big story for 1975 (all the resort areas on the West Coast are doing record business). So why fight it? The stocks in the groups above are probably going to continue to do well in 1975, and I'll be going over some of them in forthcoming reports.

GOLD: This point & figure chart tells the gold story for this week. Bullion plunged through the 170 level, dropping down to 164 on April 15, then rallying next day. I guess it just proves that supply and demand is stronger than all the rumors of what is "supposed to happen" (such as "France has to support gold at 170," etc.). At last week's 67, ASA broke its 7-month lower trendline (see chart in last Letter), and all I can say is that the bulls haven't taken charge of bullion or the gold shares yet. Maybe later, maybe in 1976, but they ain't in charge yet.



STOCKS: The Steels have put on a spectacular display during the past few months as these chart from Quote (PO Box 213, Wichita KS 67201) show. On my daily chart of US Steel, I have a perfect 5-wave advance from the January low. That usually calls for caution, and the last up-wave (of a 5-wave pattern) is usually the speculative one. A correction could take US back to the trendline that comes in around 55, at which point it could be a buy again.